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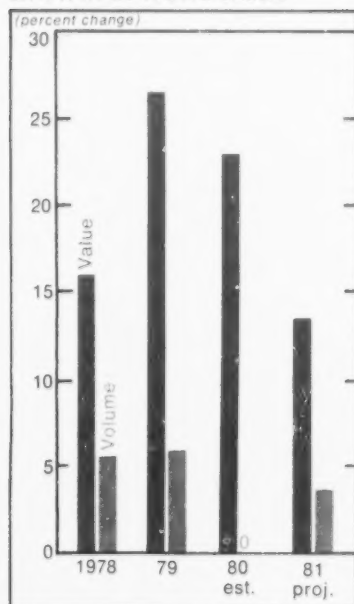
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World Trade Growth Decelerating

The volume growth of world trade will slow sharply this year, after having expanded at a relatively steady and moderately robust annual rate of 5%-6% from 1977 through 1979. The precise amount of slowdown is still somewhat uncertain. The IMF and GATT have both projected trade volume in 1980 to be 2%-3% higher than in 1979, but data for the first six months of the year suggest a much slower rate of increase. Indeed, the volume of world trade this year appears likely to be essentially the same as in 1979. This translates into a decline of about 1½% on a fourth-quarter-to-fourth-quarter basis. Given the apparent sharp falloff in trade during the second quarter—perhaps as much as 5% on a seasonally adjusted basis—even this gloomy assessment may turn out to be too optimistic if the recovery in trade expected for the fourth quarter fails to materialize.

Growth of world trade



The current slowdown in world trade differs from that of 1974-75 in two ways. The first is the closer synchronization in the current period of both the trade cycle and the cycle of overall economic activity in the industrialized countries. In 1974-75, because of heavy inventory building of raw materials and maintenance of relatively high rates of import growth by the developing economies in the early stages of the downturn, changes in the volume of trade lagged well behind changes in the level of output in the industrialized countries. Second, the current trade slowdown is likely to be milder than the 1974-75 downturn. The volume of world trade in 1975 was down 5% from the 1974 level. Although the drop in trade volume in early 1980 does appear to have been relatively sharp, the absence of speculative excesses in inventory accumulation and the lesser magnitude of the current slowdown in global economic activity in comparison with the 1974-75 recession suggest a quicker recovery of world trade this time.

Still, the pace of expansion of world trade during 1981 appears likely to be no more than moderate. Current projections suggest that the rate of increase in the level of overall economic activity in the industrialized economies next year will be relatively modest for a recovery period. Accordingly, the volume of world trade is unlikely to grow by more than 5%-6% between the fourth quarter of 1980 and the fourth quarter of 1981. If so, world trade in 1981 would only be about 3½% higher than the level expected for 1980.

German central bank again moves with restraint in easing monetary policy.

Norway's accelerating inflation creates labor unrest, but strong anti-inflation measures unlikely.

Spanish current-account gap widening, creating problems for the peseta.

Korean economy experiencing severe contraction.

The German Bundesbank has once again exercised caution in relaxing monetary policy. The central bank reduced the Lombard rate by 50 basis points to 9% and made available another short-term credit facility to the banking system at 1% below the Lombard rate. These measures follow the slight relaxation in August, when the Bundesbank also lent funds below the Lombard rate and cut reserve requirements. While the domestic economy clearly requires monetary relaxation, concern for the mark's position in foreign-exchange markets is precluding further interest-rate reductions. The authorities are expected to adopt a wait-and-see posture. If there is no adverse reaction on foreign-exchange markets and U.S. dollar rates hold stable or decline, further interest rate reductions are likely. But if the latest cuts lead to heavy losses of exchange reserves, further rate reductions will probably be postponed until underlying influences are again seen as favorable to the DM, probably around the turn of the year.

Norway's oil output continues to grow rapidly, reaching 103 million barrels in the first half of 1980. Oil earnings have thus shifted the current account into a surplus of 3.8 billion kroner for the January-June period, compared with a kr. 3.0-billion deficit in the first half of 1979. Norway's proven oil and gas reserves have recently been revised upward to 2.4 billion tons, which ensures that the country will be exporting oil for a long time to come. Traditional industries, however, are faced with declining competitiveness. The spring 1980 wage accord allowed for slight wage rises that would have boosted competitiveness. But the wage agreement assumed small price increases in 1980, and inflation has accelerated from 4.7% at yearend 1979 to 11.4% in August—with continued acceleration probable. The resultant squeeze on real incomes has fueled labor militancy and higher wage demands are imminent. The situation has been aggravated by the preferential treatment of North Sea oil workers who will receive pay rises of about 30% this year. With elections only a year away, the Government is unlikely to impose unpopular anti-inflationary measures. The authorities have so far been content only to squeeze private-sector credit by raising bank reserve requirements and interest rates.

The recent resignation of Spain's deputy prime minister and minister of economy Fernando Abril Martorel resulted in a general cabinet reshuffle and the appointment of a new economic minister, Leopoldo Calvo Sotelo. No change in economic policy is foreseen, however, despite serious concern over the economic situation. The current account recorded a deficit of \$2.4 billion in the first five months of 1980, in contrast with a surplus of \$60 million for the year-earlier period; a deficit of at least \$4 billion is likely for the year as a whole. The peseta has weakened accordingly on foreign-exchange markets, falling from 66 pesetas per U.S. dollar at the start of the year to 73. This weakness is likely to renew inflationary pressures that had moderated somewhat in the second quarter, pressures that will be heightened further by a larger-than-budgeted public deficit and continued rapid money growth. Recent policy statements by Prime Minister Suarez suggest reflationary measures in 1981. These would sustain high inflation next year, despite the expectation of continued economic weakness and high unemployment.

The Korean economy is in the midst of a sharp recession. Real GNP growth began declining last year, and in the first quarter of 1980 was negative 4%. It is therefore expected that economic growth for the current year as a whole will be negative. A poor crop is an important contributor to the economic deterioration, but the basic problem is industry. Excessive investment in heavy industry during the late 1970s overheated the economy. In addition, the country's exports suffered a loss of competitiveness and declined in volume terms last year. The sharp oil price hikes of 1979/80 have aggravated the situation and are contributing to a current-account deficit that may exceed \$5 billion this year. The Government's response to these difficulties has been to devalue and float the won, pursue a tight fiscal policy, and merge several over-expanded industries. A new set of measures announced in September includes lower interest rates and credits for the housing industry.

Mexico's rapid economic growth accompanied by rising inflation and strains on capacity.

Pakistan's rapid economic growth likely to continue, but inflation rate set to accelerate.

Indonesian oil and gas earnings growing rapidly.

OPEC meeting concludes with some progress toward price reunification.

Mexican President Lopez Portillo, in his recent State of the Nation Report, summed up Mexico's current economic position. He expressed satisfaction with an annual economic growth rate of approximately 8%, but tempered his enthusiasm with concern about a higher-than-expected rate of inflation. The rate of increase in consumer prices has risen steadily from an annualized 20% at end-1979 to nearly 26% in June. The country's rapid economic growth has also resulted in serious strains on productive capacity. Electrical brownouts have occurred, and the country's transportation system is severely strained. Nonetheless, the pace of job creation has increased, the population growth rate has fallen to less than 3%, and proven oil and gas reserves have climbed from 50 to 60 billion barrels.

In fiscal 1979/80 (ended June 30), Pakistan's real GDP is reported to have grown 6.2%, slightly faster than the previous year and nearly twice the rate of growth achieved in the 1974-77 period. Agricultural production increased 6%, while manufacturing output rose 8.1%. The outlook for economic growth during fiscal 1980/81 is favorable, but actual growth is unlikely to match last year's performance. Manufacturing should continue fairly strong, unless balance-of-payments constraints force a further tightening of controls over private-sector imports. Agricultural growth is likely to slow down, however, partly because of the large reduction in subsidies of fertilizer prices. The Pakistani consumer price index was up only 11% on a year-over-year basis in April, but the World Bank estimates that the annual rate of inflation actually reached about 20% in early 1980. The government decision to pass on to consumers the higher cost of imported oil, together with recent or planned increases in the official prices for sugar, flour, and rice, suggest that last year's inflation rate will probably be exceeded in the current fiscal year. But if the reduction in subsidies results in a lower public-sector deficit and a lower rate of domestic credit expansion, the longer-term inflation outlook will be improved.

Indonesian net foreign-exchange earnings from oil and gas will reach about \$11 billion in fiscal 1980/81 (ending in March), compared with earnings of \$4 billion only two years earlier. LNG exports, expected to net \$1 billion this year, account for an increasing portion of total receipts. Oil output has been declining from its peak of 1.69 million barrels per day in 1977 to its current level of 1.56 million barrels daily, although it is expected to rise slightly next year. Oil and gas exploration has stepped up in response to higher prices, and a number of new discoveries have been made in the last several months. Nonetheless, oil export volume, which should exceed 400 million barrels this year, may remain at this level for the next few years, despite moderate increases in production, because domestic consumption is expected to continue growing by about 12% per annum. Thanks largely to oil and gas earnings, Indonesia posted a current-account surplus of \$2 billion in fiscal 1979/80 and may chalk up a surplus of \$3 billion this year. In addition, foreign-exchange reserves are currently estimated at \$7 billion and could reach \$10 billion in 1981.

The oil, finance, and foreign affairs ministers of the OPEC member nations achieved a partial compromise at their Vienna meeting earlier this month. The meeting sought to reunify oil prices in preparation for the implementation of a long-term price-fixing formula in 1981. The formula calls for quarterly increases in Saudi marker crude tied to an average OECD growth and export inflation rate and an exchange-rate adjustment for the U.S. dollar. Sharp differences emerged between the OPEC moderates (Saudi Arabia and Iraq) and the radicals (Iran, Libya, and Algeria). The Saudis refused to discuss changes in their pricing or production until the hawks agreed to reduce their price differentials and/or premiums. The radicals insisted that the Saudis first agree to raise prices and cut output. The compromise reached has the Saudis boosting their light crude price from \$28 to \$30 per barrel—retroactive to August 1—but maintaining current output through the fourth quarter. In exchange, other members agreed to freeze their prices at current levels. A reunification of prices could occur by yearend, but the conflict between Iran and Iraq adds a serious new uncertainty.

Money Supply Control Remains Elusive

The surge in money growth in recent months has been well in excess of the short-run growth targets set by the Federal Reserve. This contrasts to the huge shortfall in money growth relative to targets that occurred during the spring. Indeed, the volatility in money growth over the last six months has been enormous by historical standards.

Interestingly, this increased volatility in money growth has appeared less than a year after the Federal Reserve altered its open market operating procedures to put greater emphasis on controlling bank reserves. The announced purpose of this shift, of course, was to increase the Fed's ability to attain its monetary growth objectives.

Most analysts believe that the unusual behavior of the money supply over the last six months is directly related to the variability in the economy during this period. For example, from February to May, when M1-B—which includes currency and checkable deposits at banks and thrift institutions—declined at an annual rate of 5%, retail sales plummeted by more than 16%. And from May to August, when M1-B grew at an annual rate of 17%, retail sales jumped by over 30%.

Even given the behavior of the economy, however, the question still arises: Why hasn't the "new" Fed policy strategy resulted in action that offsets, at least to a greater extent, the effects of short-run volatility in

total spending on short-run money supply growth? The answer, at least in part, stems from two observations. First, the Federal Reserve's ability to control the money supply in the short run through open market operations is significantly limited under the current reserve-requirement system. Second, the Federal Reserve still sets a target range for the federal funds rate—albeit a much wider one than before the announced policy change—that constrains open market operations.

The ability of the Federal Reserve to control the money supply under a reserves-targeting policy is limited because the Fed cannot always control the total amount of bank reserves in the short run. Under the current reserve-requirement system, the dollar volume of banks' reserve requirements is based upon deposit balances held two weeks earlier. Thus, banks can do nothing to alter their required reserves during any given week. And since the volume of excess reserves is usually relatively small, the total volume of bank reserves in any given week is often predetermined. Thus, changes in total reserves are *affected by*, and do not necessarily *cause*, changes in deposits.

The actual "causal chain" from reserves to money under the Fed's new policy strategy involves altering the supply of *nonborrowed reserves*—created mainly through open market operations—relative to total reserves. In following a reserves-targeting policy, the Fed

sets both a nonborrowed reserves target and a total reserves target believed to be consistent with its money supply target.

Determining the total reserves path and nonborrowed reserves path consistent with some money supply path is a tricky task. There is significant slippage in the relationship between total reserves and the money supply, since reserve requirements vary with respect to both the size of deposits and the type of deposits—some of which are not included in the money supply. Changes in the public's demand for currency relative to demand deposits also affect the relationship between reserves and the money supply.

Even given a total reserves path consistent with the money supply target, however, estimating the nonborrowed reserves path also consistent with this money target is difficult. Under these circumstances, setting a target for nonborrowed reserves is essentially equivalent to setting a target for borrowed reserves. But bank borrowings from the Fed discount window generally increase (decrease) when the federal funds rate rises (falls) relative to the discount rate. Thus, in setting a given nonborrowed reserves target, implicit assumptions are made regarding where the funds rate must trade relative to the discount rate.

Moreover, the Fed recognizes that changes in total spending over the targeted period will, other things equal, affect money supply growth. All of this implies that to set a short-run nonborrowed reserves target consistent with some money supply target, the Fed must first project total spending, and then estimate, given this projection, what levels of both the discount rate and

the funds rate will result in the targeted money growth. Even if the Fed could accurately forecast total spending, the latter estimates are subject to much uncertainty.

It is doubtful, however, that the Federal Reserve—or for that matter anyone—can accurately forecast total spending in the short run. Thus, even if the Fed somehow stumbled across the nonborrowed reserves target consistent with its money supply target, *given its projection for total spending*, inaccurate forecasts of total spending would result in deviations of money growth from target.

Finally, open market operations designed to achieve various reserves targets are still subject to the proviso that the weekly average funds rate does not move outside a specific target range. Of course, this target range has been widened considerably since the new policy was announced.

Even the new target range for the funds rate may not be large enough, however, if total spending fluctuates widely, as it has over the past six months. For example, some Federal Reserve Board governors have suggested that for the Fed to have achieved its money growth targets this spring, the funds rate would have had to fall to "unacceptable" levels. And similar constraints on upward movements in the funds rate may currently be affecting the resolve of the Fed to hit its reserves targets. On balance then, it is understandable why, given the volatility in the economy, the Federal Reserve has had difficulty controlling the short-run behavior of the money supply.

Thomas A. Lawler

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		3 months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves (less gold) in \$ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes				central bank rate in U.S. dollars September 24, 1980	exchange rate in U.S. dollars	current monetary conditions	
												latest data	consumer prices	latest data	money supply (M.)				
Austria	Strong first half leads to upward revision in official economic growth forecast for 1980 to 3.5%.	Feb.	+ 4.3%	73.1	+ 1.5%	July	4,176	+ 8.0%	2.0	0	Jan.-July current-account gap 27.6 bn. schillings, vs. 11 bn. year ago.	June	+ 7.1%	Apr.	+ 6.5%	6.75%	.0781	Money supply remains tight.	Austria
Belgium	Recession under way, with June industrial output down 0.9% from year ago; inflation easing.	May	- 6.5%	117.7	+ 3.5%	July	8,560	+ 48.0%	1.4	0	Jan.-May current-account gap was 74 bn. francs, three times year-earlier figure.	July	+ 6.6%	Mar.	- 1.0%	12.00%	.0345	Interest rates easing gradually.	Belgium
Britain	Recession intensifies; July industrial output down 8.1%; August unemployment rate at 7%.	July	- 8.5%	446.0	+ 0.9%	July	22,241	+ 9.9%	2.0	820	Jan.-Aug. current-account balance shows surplus of £ 244 million.	Aug.	+ 16.3%	June	+ 2.8%	16.00%	2.4010	Money growth above targets, but future cut in MLR likely.	Britain
Denmark	Economic activity declining, with unemployment trending upward.	Apr.	+ 2.7%	63.2	+ 3.5%	July	3,001	- 23.5%	1.8	0	Jan.-June current-account gap was 9.5 billion kroner.	June	+ 13.3%	Apr.	+ 5.9%	12.00%	.1798	EMS membership forces continued tight money conditions.	Denmark
Finland	Economic growth slowing, but still sufficiently high to reduce unemployment.	May	+ 2.7%	43.5	+ 6.7%	July	2,040	+ 0.3%	1.6	87	Jan.-July trade account shows deficit of 2.9 billion markkaa.	June	+ 11.2%	Apr.	+ 15.9%	9.25%	.2745	Monetary policy remains restrictive.	Finland
France	Economic growth has begun declining; surveys indicate pronounced business pessimism.	June	0	526.5	+ 3.4%	July	27,255	+ 1.5%	2.3	0	Trade gap remains large, but reduced import growth anticipated.	July	+ 13.6%	May	+ 8.5%	9.50%	.2395	Pressure on franc forces maintenance of high interest rates.	France
Germany	Economy dips sharply in second quarter, confirming earlier predictions of recession.	July	- 2.4%	798.5	+ 4.4%	July	50,859	+ 4.2%	3.1	0	Decline in real value of DM should help exports in 1981.	Aug.	+ 5.5%	June	+ 1.6%	7.50%	.5550	Lombard rate cut to 9%; more easing likely in coming months.	Germany
Greece	Economy expected to record zero growth in 1980; mild recovery foreseen for 1981.	May	0	37.5	+ 3.5%	June	830	- 13.7%	1.2	143	Current-account gap of some \$2.5 billion anticipated for 1980.	June	+ 27.0%	Dec.'79	+ 17.4%	20.50%	.0234	Credit conditions highly restrictive.	Greece
Ireland	GDP expected to increase only slightly this year.	Mar.	+ 0.1%	15.5	+ 1.9%	July	2,486	+ 14.7%	2.6	0	Despite strong exports, current-account gap may hit 750 mn. pounds in 1981.	May	+ 20.2%	June	- 0.4%	16.10%	2.0960	Interest rates cut, but pound holds firm.	Ireland
Italy	Sharp economic downturn in May-June; recession likely to continue into 1981.	July	+ 12.5%	323.6	+ 4.9%	July	23,440	+ 26.9%	2.8	0	Current-account gap may top \$5 billion this year.	Aug.	+ 21.6%	Apr.	+ 19.9%	15.00%	.001168	Credit remains restrictive.	Italy
Netherlands	Zero economic growth forecast for 1980; restrictive budget proposed for 1981.	June	0	156.1	+ 2.3%	July	11,226	+ 48.6%	1.6	0	Current-account deficit running nearly double last year's level.	July	+ 7.1%	May	+ 4.5%	8.50%	.5103	Interest rates ease moderately.	Netherlands
Norway	Rising oil output sustains rapid economic growth, but inflationary pressures mount.	June	+ 4.9%	46.7	+ 3.2%	July	4,727	+ 20.9%	3.3	0	Jan.-Aug. current account shows surplus of 2 bn. kroner, vs. kr. 1.1 bn. year ago.	July	+ 10.5%	Apr.	+ 6.0%	9.00%	.2058	Bank reserve requirements raised to curb inflation.	Norway
Portugal	Economic and political uncertainty prevails in advance of two upcoming elections.	Dec.	+ 6.7%	15.7	+ 3.2%	June	445	- 28.7%	0.7	155	Continued tourism strength may keep '80 current-account gap below \$800 mn.	Apr.	+ 19.5%	Jan.	+ 26.3%	18.00%	.0200	Strong credit growth expected to result in credit tightening.	Portugal
Spain	Economic activity at low level, with agricultural output the only bright spot.	Feb.	+ 8.5%	196.0	+ 1.5%	June	11,784	- 2.3%	4.5	269	Bank of Spain accumulating reserves as peseta weakens.	May	+ 13.3%	May	+ 8.3%	8.00%	.0137	Credit generally available.	Spain
Sweden	Government plans to cut public spending and reduce budget deficit to 1% of GDP.	May	- 19.0%	104.5	+ 3.8%	July	3,525	- 5.6%	1.3	0	Current account in large deficit; foreign debt mounting.	July	+ 13.2%	Dec.	+ 16.3%	10.00%	.2407	Bond rates raised to aid in financing public deficit.	Sweden
Switzerland	Real economic growth expected to be sustained throughout 1980.	Mar.	+ 9.0%	101.4	+ 0.7%	July	12,563	- 8.7%	3.9	0	Current-account gap virtually certain for 1980—first since 1965.	Aug.	+ 4.2%	June	- 8.2%	3.00%	.6056	Central bank continues to tighten monetary conditions.	Switzerland
Canada	Economy declines sharply in second quarter; housing and auto sales very weak.	June	- 2.0%	225.9	+ 2.7%	July	3,041	- 5.9%	0.6	0	Higher export prices enhance trade position.	Aug.	+ 10.7%	July	+ 3.8%	11.02%	.8586	Interest rates ease slightly.	Canada
United States	Signs of recovery from recession still unconfirmed.	Aug.	- 7.9%	2,369.0	+ 2.3%	July	10,660	+ 22.1%	0.5	0	Positive current-account balance expected in 1980.	Aug.	+ 12.8%	Aug.	+ 4.3%	10.00%	—	Interest rates and money growth have risen sharply.	United States

World Interest Rates

market rates of Sept. 24, 1980; bond yields as of Sept. 19, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	11.02	16.00	12.00	9.50	7.50	15.00 penalty rate 18.00	8.50	3.00	8.25
Day-to-Day Money	11.125 Sept. 25	9.50	15.75	7.45	11.50	9.00	16.875	9.00	6.25	11.562
Treasury Bills 91-day, Middle Rates	10.15	10.73	14.3125	12.35	12.39 one-year	n. a.	14.798 66-day	no dealing	no market	6.375 2-month
Commercial Paper prime, 3-month, asked	10.875 finance paper	10.85 finance paper 15% tax w/h	13.793	11.60 Certified	12.00 interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.10	10.80 15% tax w/h	15.00	11.60 Certified	not traded	9.90	20.20	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	11.32	13.40	12.95	11.141 20% tax w/h	12.95	8.09	15.69	10.32	4.89	8.59
Industrial Bonds prime, long-term, new and old issues, average yield	12.55 Aa Industrials	14.00	13.72	14.626	13.81	8.34	15.94	11.15	5.70	7.36
Bank Short-Term Rate to Best Borrowers (prime rate)	12.50	12.25	17.00	15.75	13.85	11.50	19.50	11.50	5.50	8.50
Bank Time Deposits 3-month	11.00 Cert. of Dep.	10.70 Cert. of Dep.	15.5625	12.30	12.00	8.25	10.75	10.125 large deposits	5.50 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	12.125	no market	15.875	no market	12.125	8.6875	no market	10.125	5.625	no market
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8586	2.4010	.0345	.2395	.5550	.001168	.5103	.6056	.004629
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	1.25 P	3.50 D	FLAT	FLAT	3.375 P	13.00 D	2.00 P	6.50 P	1.25 P
Eurodollar Deposits (London, interbank bid) Sept. 25	International Arbitrage (3-month, hedged) + in favor of U.S. dollars				Eurobonds (average yield on recent straight debt issues)			Gold Price		
7-day 11.25	U.S.-U.K. Treasury Bills + .046				U.S. Dollar Bonds			London		
1-month 11.625	U.S.-Canada Treasury Bills -1.41				7 yrs. and under 12.625			afternoon fixing		
3-month 12.00	U.S.-Canada Finance Co. Paper -1.075				Over 7 yrs. 12.875					
6-month 12.25	Eurodollars-U.K. Local Auth. Deposits + .125				DM Bonds			710.50		
					7 yrs. and under 8.375			(per fine ounce)		
					Over 7 yrs. 8.50					

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.8 (Aug.)	10.7 (Aug.)	16.3 (Aug.)	13.6 (July)	5.5 (Aug.)	21.6 (Aug.)	4.2 (Aug.)	7.7 (July)
Industrial production*	-7.6 (Aug.)	-2.0 (June)	-8.5 (July)	0 (June)	-2.4 (July)	12.5 (July)	9.0 (Mar.)	6.5 (July)
Trade balance† (billions of local currency units)	-\$1.85 (July)	C\$0.35 (July)	£0.06 (Aug.)	-FF4.89 (Aug.)	DM0.10 (July)	-Lit.1,770 (July)	-SF0.99 (July)	¥75 (Aug.)
Money supply (M₁)*	4.3 (Aug.)	3.8 (July)	2.8 (June)	8.5 (May)	1.6 (June)	19.9 (Apr.)	-6.2 (June)	0.6 (June)
Velocity of money (M₁)*	3.3 (Mar.)	6.4 (Mar.)	11.7 (Mar.)	n. a.	7.5 (Mar.)	4.3 (Mar.)	n. a.	-0.2 (Mar.)
Reserves minus gold (\$ million, change from previous month)	-90 (July)	-278 (July)	-40 (July)	1,514 (July)	1,404 (July)	2,940 (July)	-1,869 (July)	157 (July)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Chile Reaping Benefits of Economic Reform

Since bottoming out in 1975, the Chilean economy has exhibited buoyant growth in output, employment, and real wages. The public sector's financial position has improved greatly; inflation has been reduced from the 400% level to the current 30%; and international reserves, negligible in 1975, have hit a record level of \$2.4 billion.

Chile's impressive economic turnaround has occurred despite weak prices for key copper exports during most of the period, soaring oil import costs, and a heavy external debt service burden. The reason is the shift in economic orientation introduced by the military leadership, which assumed power in late 1973. Specifically, the Government of Augusto Pinochet replaced the extreme interventionist policies of the former Allende Administration with a free-market approach, with the goal of achieving a more efficient allocation of resources. This strategy required a total restructuring of the Chilean economy. The former government's stifling presence in the development process needed to be curtailed, and the country's exposure to international trade and capital had to be increased. To date, Chile has made significant progress in the needed restructuring, as recent developments in the fiscal, monetary, and external-payments areas demonstrate.

Progress on a number of fronts

On the fiscal front, the authorities have finally achieved the objective of eliminating the central government budget deficit, a goal set in 1973 when the shortfall equalled an astounding 24% of GDP. The deficit has been systematically reduced and converted into a surplus that was equivalent to 1.7% of GDP in 1979. The shift occurred as the result of tax reform measures, limitations placed on central bank lending to the Government, and, most importantly, reform of the administration and pricing policies of state enterprises, whose chronic deficits had previously represented the largest drain on the fiscal budget. Still, central government expenditures have not really declined in relation to GDP, and the authorities hope to reduce further the size of the public sector in coming years by holding the growth of public spending to a rate less than the expansion of national output.

In the financial sphere, the Government has opened up the domestic market to foreign banks and encouraged local financial institutions to borrow abroad. This liberalization has been accompanied by gradual but sizable reductions in the legal reserve requirement on 30-89-day time deposits and by a decrease in the public sector's claims on domestic credit. These actions have enhanced the efficiency of the capital market both

by expanding the amount of loanable funds available to the private sector and by lowering their cost. Accordingly, the private sector's share of domestic credit rose from 59% in 1978 to 73% in 1979, while the lending rate on 30-day loans declined from a monthly average of 5.3% in 1978 to 4.1% in 1979 and to 3% in May 1980.

The inflows of foreign capital, induced by a large differential between domestic and foreign interest rates, has also had a major expansionary impact on liquidity. In 1979 alone, the net foreign asset position of the domestic banking system shifted from minus 11.4 billion pesos to a positive 12.4 billion pesos. The foreign inflows were a principal cause of the 65% growth in domestic liquidity last year. So far this year, the money supply has sustained just as rapid a pace of increase, a product of the renewed effect of international reserve accumulation.

The challenge before the monetary authorities is to pursue a sufficiently stimulative monetary policy that will keep interest rates low to spur investment and economic activity without fueling inflation or stimulating excessive import demand. Yet control of the money supply—and of inflation—is becoming more difficult as the authorities move to eliminate all restrictions on foreign capital inflows. (Currently, external borrowings are still not permitted for periods of less than two years.) The sources of the growing difficulty are precisely the open capital market and fixed-exchange rate regime; any attempts to curb internal credit growth will now be offset by increases in international borrowing.

Recent economic performance

Chile's economic policies were instrumental in enabling the country to achieve yet another year of strong economic growth last year. Real GDP rose 8.5%, the third consecutive year in which domestic output averaged an increase of more than 8%.

Output in the construction sector grew 26% last year, compared with an average of 3.5% in the previous two years, a direct result of a delayed recovery of the housing mortgage market. The improvement in the construction sector, moreover, was the main force behind the decline in the unemployment rate to 12.7% in December 1979 from 14.8% at end-1978. Agricultural production posted gains of nearly 8%, compared with a 2.5% decline in 1978, while the mining sector grew 3%, after recording no growth in the previous year. Industrial production rose 9% in 1979, a pace that has been sustained since 1976.

There are indications that overall economic growth will be more moderate this year. During the January-June 1980 period, manufacturing output rose by a modest 3.7%, down from 10.7% in the same period

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last year. This is the result of strong import competition and the emergence of capacity constraints. The deceleration in manufacturing, coupled with weakness in agriculture and mining, suggest that the economic growth rate may fall to about 5% for 1980 as a whole.

Chile's success in slashing its inflation rate from its triple-digit level in the mid-1970s to 30% by end-1978 was primarily the result of fiscal improvements that dampened pressure on money growth. Last year, the monetary authorities concluded that the principal inflationary pressures remaining were externally fueled, since the economy was so open to international trade and capital movement. The authorities felt that by fixing the peso exchange rate to the U.S. dollar, Chilean inflation could be reduced to the level prevailing in the United States. Consequently, the system of pre-announced mini-devaluations that had been in effect since 1978 was abandoned in June 1979, and the peso was devalued by 6% and fixed at the present rate of 39 pesos per U.S. dollar. Rather than leading to lower inflation, however, the result was a temporary acceleration in inflation. The rate rose to nearly 40% by late 1979 as prices of both imports (especially of oil) and exports (mainly of copper) increased, and as capital inflows rose substantially. However, a declining trend in the monthly price increments has emerged this year. Inflation, as measured by the consumer price index, rose at an annual rate of 30% during the first seven months of 1980, down from 36% during the same period in 1979. And the improvement was even more pronounced in wholesale prices, which registered annualized increases of 32% in the first half of 1980, versus 56% in the year-earlier period.

On the external front, the combination of strong domestic activity, a large jump in the price of imported petroleum, the adoption of a fixed exchange rate, and continuation of tariff reductions boosted import expenditures from \$2.5 billion in 1978 to \$3.9 billion in 1979. This was matched, however, by a sharp increase in exports from \$2.4 billion to \$3.8 billion, a result of both a large jump in copper prices from an average of 62¢ per pound in 1978 to 90¢ per pound in 1979 and a 65% rise in non-traditional exports.

While statistics for the January-July 1980 period indicate still-rapid growth for exports and imports

(export shipments rose 48% above the previous year's level and registered imports increased 40%), their growth rate has slowed more recently. The export slowdown is the result of a combination of two forces: declining copper prices since the first quarter—the consequence of economic weakening abroad—and the negative impact on the competitiveness of non-traditional exports of present exchange-rate policy—which has led to an appreciation of the peso of at least 20% in real terms between June 1979 and July 1980. Import growth, on the other hand, is lessening as a consequence of the slower pace of domestic economic expansion. Thus, exports could reach \$5 billion in 1980, while imports may climb to \$5.3 billion. The resultant trade deficit, when combined with a projected \$1-billion deficit in the services and transfers account, should yield a current-account deficit of some \$1.3 billion this year, up from the \$900-million deficit posted in 1979.

Foreign capital inflows, primarily private, are expected to meet the country's financial requirements with ease. They are also expected to boost international reserves to \$2.8 billion by yearend. With this scenario, Chile's total foreign debt will rise to about \$10.3 billion by the end of 1980, up from \$8.5 billion at end-1979. Such an increase, however, represents a decline in the debt burden relative to national income and exports.

Growth prospects favorable

The opening up of the Chilean economy, combined with the introduction of a free-market mechanism for resource-allocation purposes, has led to rapid economic expansion and laid the foundation for sound and self-sustaining growth. Real economic growth in excess of 6% per annum over the next two to three years is a possibility. But this assumes maintenance of a stimulative economic policy that will boost investment and an exchange-rate policy that supports vigorous economic growth—especially in manufacturing—without undermining export-oriented industries and incurring large current-account deficits. Conduct of such a stimulative policy, however, would mean that Chilean inflation would be unlikely to drop to the world level, although a gradual decline in the rate of price increase could materialize if import and export prices were to stabilize.

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